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Still Solvent: The Third Circuit Continues to Support "Deepening Insolvency" as a Viable Tort Claim in In re Lemington Home for the Aged

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STILL SOLVENT: THE THIRD CIRCUIT CONTINUES TO SUPPORT "DEEPENING INSOLVENCY" AS A VIABLE TORT CLAIM IN *IN RE LEMINGTON HOME FOR THE AGED*

ERIC KIM*

"A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[1]

I. INTRODUCTION

Vince Lombardi, the wildly successful head coach of the 1960s era Green Bay Packers, is credited with once saying that "winners never quit and quitters never win."[2] As admirable as this old adage on perseverance may seem, directors of insolvent corporate entities face an extremely complex situation, where choosing to liquidate—or "quitting"—may often be the best option to maximize value for shareholders and creditors.[3] Recently, however, some courts held directors tortiously liable for not dissolving a corporation soon enough.[4] More specifically, under the theory of "deepening insolvency" many jurisdictions began to hold that directors who continue to prolong the life of an insolvent corporation can be personally liable for any damages caused as a result.[5] Consequently, in juris-

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1. *See* Funding Corp. of N.Y. v. Dansker (*In re* Investors Funding Corp. of N.Y. Sec. Litig.), 523 F. Supp. 533, 541 (S.D.N.Y. 1980) (explaining how prolonging insolvent corporate entity's existence may actually be harmful).

2. *See* Eugene Volokh, *The Mechanisms of the Slippery Slope*, 116 HARV. L. REV. 1026, 1052 n.71 (2003) (discussing clichéd maxim in society that quitting is bad and attributing "winners never quit" saying to Vince Lombardi, famous head coach of Green Bay Packers football team).

3. *See* Sabin Willett, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549, 551–53 (2005) (explaining nature of insolvency and discussing how keeping corporation in existence after it has continually been insolvent or unprofitable only hurts shareholders—who are residual claimants upon liquidation—and creditors).

4. *See* Jay Bender, *Deepening Insolvency in Alabama: Is It a Tort, a Damages Theory or Neither of the Above?*, 66 ALA. LAW. 190, 191–93 (2005) (examining deepening insolvency's history from 1980); Douglas R. Richmond et al., *Lawyer Liability and the Vortex of Deepening Insolvency*, 51 ST. LOUIS U. L.J. 127, 131–32 (2006) (discussing history behind deepening insolvency and tort's origins from dicta in New York district court case).

5. *See* OHC Liquidation Trust v. Credit Suisse First Bos. (*In re* Oakwood Homes Corp.), 340 B.R. 510, 530 (Bankr. D. Del. 2006) (discussing development of deepening insolvency and its definition); Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* VarTec Telecom, Inc.), 335 B.R. 631, 636–38 (Bankr. N.D. Tex. 2005) (discussing rationale behind deepening insolvency); Limor v. Buerger (*In re* Del-Met Corp.), 322 B.R. 781, 815

dictions that subscribe to deepening insolvency, creditors could use the theory to file claims against directors, officers, and anyone playing a substantial role in a business entity's management.[6]

The debate on deepening insolvency has been contentious, to say the least.[7] Corporate practitioners and their clients have lamented that deepening insolvency circumvents the business judgment rule and places too much liability on a corporation's management.[8] Many academics have heralded the theory as an innovative addition to corporate and bankruptcy law.[9] Other commentators have predicted that deepening insolvency could lead directors to liquidate a corporation too soon.[10] On the

(Bankr. M.D. Tenn. 2005) (defining deepening insolvency); Kittay v. Atlantic Bank of N.Y. (*In re* Global Serv. Grp.), 316 B.R. 451, 456 (Bankr. S.D.N.Y. 2004) ("'Deepening insolvency' refers to the 'fraudulent prolongation of a corporation's life beyond insolvency,' resulting in damage to the corporation caused by increased debt.").

6. *See* Official Comm. of Unsecured Creditors of Wickes, Inc. v. Wilson, No. 06-0869, 2006 WL 1457786 (N.D. Ill. May 23, 2006) (proceeding brought by bankruptcy trustee against directors and officers of corporation); Bondi v. Grant Thornton Int'l (*In re* Parmalat Sec. Litig.), 377 F. Supp. 2d 390 (S.D.N.Y. 2005) (describing how bankruptcy trustee filed claims against auditors); *In re Oakwood Homes*, 340 B.R. at 510 (liquidating trust files deepening insolvency claim against principle lender of debtor); Nisselson v. Ford Motor Co. (*In re* Monahan Ford Corp. of Flushing), 340 B.R. 1 (Bankr. E.D.N.Y. 2006) (describing how bankruptcy trustee filed deepening insolvency claims against corporation's lender and accountants); Devon Mobile Commc'ns Liquidating Trust v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns Corp.), Bankr. No. 02–41729, 2006 WL 687153 (Bankr. S.D.N.Y. Mar. 6, 2006) (liquidating trust files deepening insolvency claims against general partner); Miller v. Dutil (*In re* Total Containment, Inc.), 335 B.R. 589 (Bankr. E.D. Pa. 2005) (describing how bankruptcy trustee filed deepening insolvency claims against directors and officers of corporation); *In re VarTec Telecom*, 335 B.R. at 631 (proceeding brought by unsecured creditors against secured creditors for deepening insolvency).

7. *See* TaeRa K. Franklin, *Deepening Insolvency: What It Is and Why It Should Prevail*, 2 N.Y.U. J.L. & BUS. 435, 437 (2006) (arguing that deepening insolvency is good for maximizing shareholder value and should continue as part of bankruptcy jurisprudence); Richmond et al., *supra* note 4, at 156 (discussing how deepening insolvency is becoming too expansive).

8. *See* Daniel E. Harrell, Comment, *Pandora's Bankruptcy Tort: The Potential for Circumvention of the Business Judgment Rule Through the Tort Theory of Deepening Insolvency*, 36 CUMB. L. REV. 151, 152–54 (2006) ("A key issue concerning the deepening insolvency theory is its potential to extend to the point that it would threaten the business judgment presumption altogether."); Willet, *supra* note 3, at 560–62 (supporting recent holdings that gave directors protection from deepening insolvency claims through business judgment rule).

9. *See* Phillip G. Lewis, Note, *"Deep" Impact: Can a Tort Theory of Deepening Insolvency Survive in the "Options Backdating" Era?*, 95 KY. L.J. 919, 919 (2007) ("Despite humble beginnings as mere dictum in a 1983 Seventh Circuit opinion, the theory of deepening insolvency has seen a rapid expansion within the legal community, becoming the object of much scholarly debate." (footnote omitted)).

10. *See* David C. Thompson, Note, *A Critique of "Deepening Insolvency," a New Bankruptcy Tort Theory*, 12 STAN. J.L. BUS. & FIN. 536, 546 (2007) ("Many floundering businesses are able to emerge from insolvency and provide a positive return to shareholders while fulfilling debt obligations more completely than if they had been forced to liquidate."). A related concern is that having deepening insolvency

contrary, shareholders and creditors have generally supported the theory by arguing that it merely ensures that actions are taken to maximize corporate value.[11] This disparity has extended to the courts, as the lower federal and state courts continue to disagree on the divisive theory.[12] Some have held that deepening insolvency should be considered a form of damages for other torts such as negligence or malpractice.[13] Others have held that deepening insolvency should be an independent tort claim.[14]

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as a tort creates inconsistencies for directors' and officers' fiduciary duties of care and loyalty, which may require them to try and save an insolvent corporation with more capital (i.e., loans). *See id.* at 545–47 (discussing inconsistencies between deepening insolvency and fiduciary duties).

11. *See* Thomas J. Vollbrecht & Theresa A. Gooley, *"Deepening Insolvency" Claims: Can You Become More Bankrupt? Can You (Or Someone Else) Sue If You Do?*, 13 FIDELITY L.J. 167, 169–76 (2007) (discussing how courts started to realize that prolonging insolvent corporation's life actually harmed corporation and shareholders).

12. *Compare* Christians v. Grant Thornton L.L.P., 733 N.W.2d 803, 811 (Minn. Ct. App. 2007) (holding that deepening insolvency is not valid theory of damages), *and* Kaye v. Dupree (*In re* Avado Brands, Inc.), 358 B.R. 868, 886 (Bankr. N.D. Tex. 2006) (choosing not to recognize deepening insolvency as valid cause of action), *and* Official Comm. of Unsecured Creditors *ex rel.* Felt Mfg. Co. v. Foss (*In re* Felt Mfg. Co.), 371 B.R. 589, 623 (Bankr. D.N.H. 2007) (predicting that New Hampshire Supreme Court could not accept deepening insolvency as an independent cause of action), *and* Joseph v. Frank (*In re* Troll Commc'ns, L.L.C.), 385 B.R. 110, 121 (Bankr. D. Del. 2008) (recognizing rejection of deepening insolvency under Delaware law), *and In re Parmalat*, 377 F. Supp. 2d at 419 (applying Illinois law to hold that plaintiff's deepening insolvency claim should be dismissed as duplicative of malpractice claim), *and* Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 205 (Del. Ch. 2006) (rejecting deepening insolvency as cause of action), *with* Seitz v. Detweiler, Hershey & Assocs. (*In re* CitX Corp.), 448 F.3d 672, 678 (3d Cir. 2006) (finding that deepening insolvency is valid cause of action in Pennsylvania), *and In re* Parmalat Secs. Litig., 501 F. Supp. 2d 560, 560, 573–77 (S.D.N.Y. 2007) (examining deepening insolvency as theory of damages through dicta), *and* NCP Litig. Trust v. KPMG, 945 A.2d 132, 143 (N.J. Super. Ct. Law Div. 2007) (holding that New Jersey state law recognizes deepening insolvency as valid theory of damages and action), *and* Smith v. Arthur Andersen L.L.P., 421 F.3d 989, 1003 (9th Cir. 2005) (agreeing with theory of deepening insolvency without determining whether it is valid cause of action), *and* Thabault v. Chait, 541 F.3d 512, 521 (3d Cir. 2008) (predicting that even though New Jersey Supreme Court or legislature has never recognized deepening insolvency as theory of damages it anticipates that state will).

13. *See* Vieira v. AGM II, L.L.C. (*In re* Worldwide Wholesale Lumber, Inc.), 378 B.R. 120, 127 (Bankr. D.S.C. 2007) (recognizing deepening insolvency as theory of damages for breach of fiduciary duty claim); Schnelling v. Crawford (*In re* James River Coal Co.), 360 B.R. 139, 179–80 (Bankr. E.D. Va. 2007) (recognizing deepening insolvency as theory of damages not independent cause of action); Collins v. Kohlberg & Co. (*In re* Sw. Supermarkets, L.L.C.), 325 B.R. 417, 429 (Bankr. D. Ariz. 2005) (examining deepening insolvency in context of theory of damages).

14. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 345–47 (3d Cir. 2001) (holding that deepening insolvency tort claim is valid in Pennsylvania).

But like any novelty, deepening insolvency appeared to rapidly lose its popularity.[15] The turning point came from the highly influential Delaware Court of Chancery ("Chancery Court") in the case of *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,[16] where the court not only affirmatively rejected deepening insolvency as a tort claim, but actually reprimanded the Bankruptcy Court for the District of Delaware for assuming that Delaware state law would support such a conclusion.[17] Subsequently, the *Trenwick* court's decision to discard deepening insolvency led other courts to follow suit.[18] Since 2006, many jurisdictions have either completely rejected the theory, or at the very least, marginalized it.[19]

The Third Circuit originally appeared to be a firm supporter of deepening insolvency through its expansive holding in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*,[20] where the court first established deepening insolvency as a viable tort claim in Pennsylvania.[21] Later, the

15. *See* Bondi v. Citigroup, Inc., No. 10902-04, 2005 WL 975856, at *21 (N.J. Super. Ct. Law Div. Feb. 28, 2005) (rejecting deepening insolvency as independent tort); Coroles v. Sabey, 79 P.3d 974, 983 (Utah Ct. App. 2003) ("Although deepening insolvency might harm a corporation's shareholders, it does not, without more, harm the corporation itself."); *see also* Harrell, *supra* note 8, at 152–53 ("A major problem with the deepening insolvency theory of tort liability is its novelty.").

16. 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Trust v. Billett, No. 495, 2006 , 2007 WL 2317768 (Del. Aug. 13, 2007).

17. *See id.* at 204 ("The concept of deepening insolvency has been discussed at length in federal jurisprudence, perhaps because the term has the kind of stentorious academic ring that tends to dull the mind to the concept's ultimate emptiness."). Furthermore, the Delaware Chancery Court stated:

> Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm. As a thoughtful federal decision recognizes, Chapter 11 of the Bankruptcy Code expresses a societal recognition that an insolvent corporation's creditors (and society as a whole) may benefit if the corporation continues to conduct operations in the hope of turning things around.

Id. (opining that theories such as deepening insolvency could not impose duty to liquidate when State would like directors to put forth their utmost effort to save insolvent corporation).

18. *See* Wooley v. Faulkner (*In re* SI Restructuring, Inc.), 532 F.3d 355, 363 (5th Cir. 2008) ("In the Delaware Court of Chancery, the doctrine of deepening insolvency as an independent cause of action or as a theory of damages was also considered and rejected . . . ."); Official Comm. of Unsecured Creditors of Propex, Inc. v. BNP Paribas (*In re* Propex, Inc.), 415 B.R. 321, 331 (Bankr. E.D. Tenn. 2009) ("The current state of affairs with regard to deepening insolvency, as the court sees it, is that the theory is still obscure and difficult to distinguish from existing torts . . . ."); Christians v. Grant Thornton, L.L.P., 733 N.W.2d 803, 812 (Minn. Ct. App. 2007) (holding that deepening insolvency is not recognized form of corporate damage in Minnesota).

19. For a further discussion of how various state jurisdictions began to marginalize deepening insolvency, see *supra* note 16 and accompanying text.

20. 267 F.3d 340 (3d Cir. 2001).

21. *See id.* at 344 ("We conclude that 'deepening insolvency' constitutes a valid cause of action under Pennsylvania state law and that the Committee therefore has standing to bring this action."). When the *Lafferty* holding first came out,

Circuit seemed to follow the Delaware Chancery Court through its holding in *In re CitX Corp.*[22] There, the court unequivocally limited deepening insolvency to conduct involving fraud and held that the theory only applied as an independent tort and not as a form of damages.[23] Many practitioners and academics viewed the *CitX* decision as marginalizing the holding of *Lafferty*, furthering the assumption that deepening insolvency would meet the same fate in Pennsylvania that it had met in Delaware.[24] Nonetheless, in the recent case *In re Lemington Home for the Aged*,[25] the Third Circuit surprised many practitioners by not only affirming the continued existence of deepening insolvency, but also vacating a dismissal of the appellant's deepening insolvency claim, strongly suggesting that the tort still has its "teeth."[26]

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many academics and practitioners viewed it as the single most influential ruling on deepening insolvency, particularly because it validated the theory as an independent cause of action in tort. *See* Laura Colasacco, Note, *Where Were the Accountants? Deepening Insolvency As a Means of Ensuring Accountants' Presence When Corporate Turmoil Materializes*, 78 FORDHAM L. REV. 793, 827 (2009) ("*Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, is the pivotal case that defined deepening insolvency as an independent tort."). Through *Lafferty*, the Third Circuit was the first federal circuit court to address the claim of deepening insolvency and embrace the concept of deepening insolvency as an independent tort. *See* Hugh M. McDonald et al., Lafferty*'s Orphan: The Abandonment of Deepening Insolvency*, AM. BANKR. INST. J., Dec.–Jan. 2008, at 1, 57–58 ("However, the theory did not fully evolve until the Court of Appeals for the Third Circuit's decision in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co. Inc.*").

22. Seitz v. Detweiler, Hershey & Assocs. (*In re* CitX Corp.), 448 F.3d 672 (3d Cir. 2006).

23. *See id.* at 677 ("Although we did describe deepening insolvency as a 'type of injury,' and a 'theory of injury,' we never held that it was a valid theory of damages for an independent cause of action." (citations omitted)).

24. *See* Michelle M. Harner & Jo Ann J. Brighton, *The Implications of* North American Catholic *and* Trenwick*: Final Death Knell for Deepening Insolvency? Shift in Directors' Duties in the Zone of Insolvency?*, 2008 ANN. SURV. BANKR. L. 1 ("The Third Circuit subsequently backed away from its position in *Lafferty* regarding deepening insolvency and the types of injury subject to redress in *CitX Corp.*"). As one commentator noted:

> [T]he Third Circuit in *CitX* took aim at deepening insolvency and successfully limited its reach in three ways: (1) the court held that deepening insolvency may not be invoked as a theory of damages to support a malpractice cause of action; (2) the court ruled that a deepening insolvency claim cannot be sustained solely on an allegation of negligent conduct; and (3) the court ruled that *Lafferty*'s precedential value was limited to courts within Pennsylvania.

Ian T. Mahoney, *The* CitX *Decision: Has the Tort of "Deepening Insolvency" Gone Bankrupt?*, 52 VILL. L. REV. 995, 1009 (2007) (footnotes omitted).

25. Official Comm. of Unsecured Creditors v. Baldwin (*In re* Lemington Home for the Aged), 659 F.3d 282 (3d Cir. 2011).

26. *See* D.J. Baker et. al., *Corporate Governance of Troubled Companies and the Role of Restructuring Counsel*, 63 BUS. LAW. 855, 864 (2008) (discussing some threats unsecured creditors will pose to directors of bankrupt corporations and how these threats, including deepening insolvency, have "teeth"); *Third Circuit Address "Deepening Insolvency" Claims: In re* Lemington Home, ALERT MEMO (Cleary, Gottlieb, Steen & Hamilton L.L.P., New York, N.Y.),Oct. 12, 2011, at 1, *available at* http://

This Casebrief serves as an update on deepening insolvency within the Third Circuit jurisprudence and aims to give legal practitioners a guide to understanding the mechanisms of the controversial but resilient tort.[27] Part II provides a more detailed overview of the judicial decisions that led to the development of deepening insolvency.[28] Part III examines the holding in *Lemington* and how the case fits into the Third Circuit jurisprudence.[29] Finally, Part IV analyzes the potential impact of *Lemington* and concludes that practitioners in Pennsylvania should continue to be aware of the deepening insolvency tort when advising directors, officers, and any professionals working for unsuccessful or insolvent corporations.[30]

II. THE CONTEMPORARY HISTORY AND DEVELOPMENT OF DEEPENING INSOLVENCY

A. *Conceived from the Depths of Dicta*

It is important to remember that deepening insolvency is not based on any bankruptcy code or statute, but rather was born from common law.[31] As such, the exact origin of deepening insolvency is difficult to pinpoint.[32] However, it is widely believed that the theory evolved from cases in the 1980s concerning breach of fiduciary duty claims against directors who fraudulently prolonged the life of their corporations.[33] In

www.cgsh.com/files/News/1401f0e9-32a9-4a8d-b289-65dec0d39cf0/Presentation/NewsAttachment/5d5a80fe-ace0-4577-86ff-663837aff027/CGSH%20Alert%20-%20In%20re%20Lemington%20Home.pdf (warning clients that deepening insolvency is still viable tort in Third Circuit); *Third Circuit: In Pennsylvania, Creditors' Deepening Insolvency Claims Still Fair Game*, GIBBONS BUS. LITIG. ALERT (Gibbons P.C., Newark, N.J.), Nov. 4, 2011, *available at* http://www.businesslitigationalert.com/2011/11/04/third-circuit-in-pennsylvania-creditors%E2%80%99-deepening-insolvency-claims-still-fair-game/ (alerting practitioners that Third Circuit recently reaffirmed deepening insolvency); *Third Circuit Addresses Breach of Fiduciary Duty and Deepening Insolvency Claims Under Pennsylvania Law*, INSIGHTS (Skadden, Arps, Slate, Meagher & Flom L.L.P., Wilmington, Del.), Oct. 3, 2011, *available at* http://www.skadden.com/newsletters/Third_Circuit_Addresses_Breach_of_Fiduciary_Duty_and_Deepening_Insolvency_Claims_Under_Pennsylvania_Law.pdf (discussing return of deepening insolvency in wake of *Lemington* holding by Third Circuit).

27. For a discussion on how the *Lemington* decision impacts practitioners, see *infra* notes 122–46 and accompanying text.

28. *See infra* notes 34–78 and accompanying text.

29. *See infra* notes 79–121 and accompanying text.

30. *See infra* notes 122–46 and accompanying text.

31. *See* Official Comm. of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* VarTec Telecom, Inc.), 335 B.R. 631, 638–39 (Bankr. N.D. Tex. 2005) ("The words 'deepening insolvency' are neither contained in the Bankruptcy Code, nor do they arise from other federal law, so the courts that consider the theory . . . to be an actionable tort do so by predicting how their respective state courts would rule when adopting a new cause of action.").

32. *See* Vollbrecht & Gooley, *supra* note 11, at 169–78 (discussing history of deepening insolvency and its possible origins).

33. *See* Elizabeth V. Tanis & Jennifer D. Fease, *Emerging Issues in Deepening Insolvency: Causation and Pitfalls of Measuring Damages as the Debtor's Liabilities*, A.L.I.-

these cases, directors would often attempt to use the *in pari delicto* defense to argue that they could not be held liable for prolonging a corporation's life, under any circumstances, because doing so benefited the corporation.[34] A New York district court faced such an argument in the case *In re Investors Funding Corporation of New York Securities Litigation*.[35] There, the court ruled that extending the life of a corporation is not per se beneficial.[36] Three years later, the Seventh Circuit in *Schacht v. Brown*,[37] dealt with similar facts and held that the *in pari delicto* defense did not apply because extending the life of the corporation created an adverse interest.[38] Accordingly, after the various courts began to consistently hold that lengthening the existence of an unsuccessful corporation is not necessarily good for the shareholders and creditors, the natural progression continued toward deepening insolvency.[39]

B. *An Unprecedented Growth Spurt*

The idea that directors could be held liable for prolonging the life of an insolvent corporation quickly garnered the interests of creditors and trustees of bankruptcy estates.[40] Prior to deepening insolvency, unsecured creditors had very few options to recover their losses from a bankrupt cor-

A.B.A. BUS. L. COURSE MATERIALS J., Apr. 2010, at 46–47 (reviewing history of deepening insolvency and its roots that developed from *in pari delicto* defense).

34. *See* Henry S. Bryans, *Claims Against Lawyers by Bankruptcy Trustees—A First Course on the In Pari Delicto Defense*, 66 BUS. LAW. 587, 597 (2011) ("The defense of *in pari delicto* at common law was based 'on two premises: first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.'"). With an *in pari delicto* claim, defendants are arguing that they should not be held liable for actions that can be imputed onto the plaintiff. *See id.* at 595 (explaining mechanics of *in pari delicto* defense in bankruptcy trustee situations). In the context of corporations, a director's actions can be imputed onto the corporation if it was done within the scope of the director's duty and for the corporation. *See id.* at 597 (describing when director's actions are imputed to corporation). Thus, a shareholder cannot sue a director who engaged in fraudulent activities if the fraud actually benefited the corporation. *See id.* (detailing how *in pari delicto* precludes bankruptcy trustee's claims against directors).

35. Bloor v. Dansker, (*In re* Investors Funding Corp. of N.Y. Sec. Litig.), 523 F. Supp. 533 (S.D.N.Y. 1980).

36. *See id.* at 541 (discussing how corporations are not like biological entities where prolonging their existence is automatically beneficial).

37. 711 F.2d 1343 (7th Cir. 1983).

38. *See id.* at 1350 ("[F]or the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability."). The Seventh Circuit was combating the notion that a corporation cannot sue for conduct that prolonged its life, regardless of whether it was done fraudulently. *See id.* ("For each of these cases rests upon a seriously flawed assumption, *i.e.*, that the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests.").

39. *See* Tanis & Fease, *supra* note 36, at 607–09 (describing how deepening insolvency theory evolved from failed *in pari delicto* defenses).

40. *See generally* David E. Gordon, Comment, *The Expansion of Deepening Insolvency Standing: Beyond Trustees and Creditors' Committees*, 22 EMORY BANKR. DEV. J. 221

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poration.[41] Consequently, some commentators argue that deepening insolvency became rapidly popular out of necessity.[42] Others have a more cynical view.[43] Opponents of deepening insolvency often argue that the theory only gained traction during the early twenty-first century, when large corporate scandals such as Enron and WorldCom ignited a public outcry.[44] Yet for whatever reason, the rapid rise of deepening insolvency is undeniable.[45] Within a couple decades, what started out as dicta evolved into a complex cause of action and theory of damages in several jurisdictions.[46]

Despite deepening insolvency's initial popularity, the theory lacked the substance to be considered a bona fide tort until the Third Circuit definitively defined it as such in *Lafferty*.[47] There, the court dealt with a

(discussing how deepening insolvency expanded remedies available for creditors and bankruptcy trust estates.)

41. *See* Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. PA. L. REV. 777, 806 (2007) (describing rights of unsecured creditors as akin to residual claimants of dissolved corporation).

42. *See* Franklin, *supra* note 7, at 477–78 (detailing events such as collapse of Enron as catalyst for deepening insolvency and arguing that deepening insolvency is needed to further regulate corporate misconduct).

43. *See* J.B. Heaton, *Deepening Insolvency*, 30 J. CORP. L. 465, 500 (2005) (arguing that certain notions of deepening insolvency are "unsupported in financial economics and inconsistent with the traditional understandings and economic functions of corporate injury"); Thompson, *supra* note 10, at 537 (arguing that deepening insolvency should not be viable tort or theory of damages).

44. *See* Thompson, *supra* note 10, at 536 (describing public hysteria caused by Enron scandal and how this may have led to juror support of deepening insolvency).

45. *See The Deepening Insolvency Risk*, MEMORANDUM (Foster Pepper P.L.L.C., Seattle, Wash.), June 1, 2006, at 1, *available at* http://www.foster.com/pdf/DeepeningInsolvencyRisk.pdf ("The past few years have seen an ever increasing number of reported lawsuits asserting . . . 'deepening insolvency.' From only 4 or 5 in the year 2000 to well over 55 in the years 2004 and 2005. Anecdotal evidence suggests that far more have been filed and not reported.").

46. *See* Willett, *supra* note 3, at 550 (discussing rapid development of deepening insolvency). A partner at the prominent law firm, Bingham McCutchen L.L.P., Sabin Willett actually compared deepening insolvency to evolution in the following manner:

> Doctrines are like life: complex organisms evolve from the most unremarkable amino acids. Within a generation of *Schacht*, federal courts were issuing pronouncements that "'deepening insolvency' constitutes a *valid cause of action* under Pennsylvania state law," and that Delaware recognizes a "tort of deepening insolvency." In *In re Exide Technologies, Inc.*, a court let discovery proceed on a "deepening insolvency" claim against lenders who make loans to distressed buyers. *This is evolution at light speed.* What was merely a failed defense in *Schacht* now walks on all fours and demands recognition by legal taxonomists as a fully-fledged cause of action.

Id. (emphasis added) (footnotes omitted).

47. *See* Gordon, *supra* note 43, at 224–25 ("Beginning with a 2001 decision from the Third Circuit Court of Appeals in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, courts began to recognize deepening insolvency as an independent cause of action."); McDonald et al., *supra* note 22, at 57 ("Despite the narrow

committee of unsecured creditors filing a derivative action on behalf of the debtor corporation against the board of directors.[48] The committee's complaint alleged violations of federal securities laws, breach of fiduciary duty, and other related claims arising from a ponzi scheme in which the defendants were fraudulently issuing corporate bonds.[49] As a basis for these claims, and because a derivative action requires a plaintiff to allege harms inflicted on the corporation, the committee cited deepening insolvency.[50] Although the Third Circuit ultimately affirmed the district court's decision to dismiss the committee's claims, the court affirmatively acknowledged deepening insolvency as an independent tort claim in Pennsylvania.[51] The Third Circuit based its opinion on the Seventh Circuit's dicta in *Schacht* and predicted that the Pennsylvania Supreme Court would soon establish deepening insolvency as an independent cause of action.[52]

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application of *Investors Funding* and *Schacht*, the concept was greatly expanded nearly two decades after *Investors Funding* by the Third Circuit in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co. Inc.*"); Thompson, *supra* note 10, at 538 ("*Lafferty* is generally recognized as the first reported case that established deepening insolvency as an independent cause of action in tort.").

48. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 344 (3d Cir. 2001) (describing procedural posture of case).

49. *See id.* at 344 (discussing background facts from case and how it arose from collapsed ponzi scheme).

50. *See id.* at 349–51 (examining claims made).

51. *See id.* at 359 (affirming district court's decision to grant summary judgment against appellant's deepening insolvency claims).

52. *See id.* at 350 (citing Seventh Circuit as basis for rationale that deepening insolvency should be considered independent tort in Third Circuit). The *Lafferty* court quoted the following passage from the Seventh Circuit's *Schacht* holding:

> [C]ases [that oppose "deepening insolvency"] rest[ ] upon a seriously flawed assumption, i.e., that the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests. This premise collides with common sense, for the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability. Indeed, in most cases, it would be crucial that the insolvency of the corporation be disclosed, so that shareholders may exercise their right to dissolve the corporation in order to cut their losses. Thus, acceptance of a rule which would bar a corporation from recovering damages due to the hiding of information concerning its insolvency would create perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body as long as possible.

Id. (alterations in original) (quoting Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983)). Furthermore, the *Lafferty* court concluded that deepening insolvency was based on the fundamentally sound rationale that increasing an already insolvent corporation's debt hurts the corporation. *See id.* at 349 ("First and foremost, the theory is essentially sound. . . . Even when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways.").

The Third Circuit's holding in *Lafferty* had a ripple effect on not only the courts in its own jurisdiction, but on other circuits as well.[53] Most notably, the Bankruptcy Court for the District of Delaware cited *Lafferty* in holding that deepening insolvency was also a viable tort in Delaware.[54] Consequently, after *Lafferty*, the theory grew exponentially to the point where anyone involved in deepening a corporation's insolvency could be held liable, even creditors and lawyers.[55] Furthermore, some courts began to hold that mere negligence could be enough to support a deepening insolvency claim.[56] This evolution was somewhat unexpected, considering that the court in *Lafferty* simply found deepening insolvency to be a valid tort and still affirmed a dismissal of the plaintiff's claims.[57] Regardless, many academics and practitioners began to fear that the theory would grow too large.[58]

C. *The Ringing Death Knell*

Just when deepening insolvency gained significant momentum in the courts, the tide turned against it.[59] Although many scholarly articles criti-

53. *See* Crowley v. Chait, No. 85-2441, 2004 WL 5434953, at *18–19 (D.N.J. Aug. 25, 2004) (citing *Lafferty* to hold that plaintiff has valid deepening insolvency claim); Official Comm. of Unsecured Creditors & R2 Invs., LDC v. Credit Suisse First Bos. (*In re* Exide Techs., Inc.), 299 B.R. 732, 752 (Bankr. D. Del. 2003) (citing *Lafferty* to hold that deepening insolvency is valid tort); Tabas v. Greenleaf Ventures, Inc. (*In re* Flagship Healthcare, Inc.), 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001) (citing *Lafferty* to hold plaintiffs pled sufficient facts for deepening insolvency claim).

54. *See Exide Techs.*, 299 B.R. at 752 ("[B]ased on the Third Circuit's decision in *Lafferty* and the Delaware courts' policy of providing a remedy for an injury, I conclude that Delaware Supreme Court would recognize a claim for deepening insolvency when there has been damage to corporate property.").

55. *See* Kittay v. Atlantic Bank of N.Y. (*In re* Global Serv. Grp.), 316 B.R. 451, 454–55 (Bankr. S.D.N.Y 2004) (examining how shareholder plaintiffs brought action against creditor for extending loans to corporation prior to bankruptcy and increasing corporation's insolvency, which led to deepening insolvency claim).

56. *See In re Flagship Healthcare*, 269 B.R. at 727–28 (holding that plaintiff's allegations of defendant's negligent conduct were sufficient for deepening insolvency claim); Smith v. Arthur Andersen L.L.P., 421 F.3d 989, 995 (9th Cir. 2005) (recognizing deepening insolvency for unintentionally misrepresenting firm's insolvency).

57. *See Lafferty*, 267 F.3d at 344 (affirming district court's holding granting summary judgment for defendant and dismissing deepening insolvency claim).

58. For a discussion of the various academics and scholars that criticized deepening insolvency, see *supra* note 9 and accompanying text.

59. *See* McDonald et al., *supra* note 22, at 60 (discussing how tide turned against deepening insolvency and how courts began to reject theory). The *CitX* and *Trenwick* holdings by the Third Circuit and Delaware Chancery Court, respectively, were seen as the catalyst for many other jurisdictions rejecting deepening insolvency. *See id.* ("The decisions in *CitX* and *Trenwick* have led some courts to take a more narrow view of deepening insolvency, with many courts refusing to recognize the theory as a cause of action or greatly restricting it as a theory of damages."). *See also* Buckley v. Deloitte & Touche USA L.L.P., No. 06-3291, 2007 WL 1491403, at *10 (S.D.N.Y. May 22, 2007) (noting deepening insolvency is not

cized the theory, the turning point came from the Delaware Chancery Court in *Trenwick*.[60] There, the court dealt with a holding company that had been rendered insolvent by its acquisition of too many subsidiary insurance companies negatively affected the 9/11 attacks.[61] The plaintiffs filed claims under deepening insolvency and the Delaware Chancery Court granted the defendant's motion to dismiss, holding that deepening insolvency was not a valid cause of action under state law.[62] The Delaware Supreme Court promptly affirmed the Chancery Court's ruling.[63]

The Delaware Chancery Court's primary concerns regarding deepening insolvency were similar to those raised by practitioners and scholars who criticized the theory.[64] More specifically, the *Trenwick* court recognized that directors and officers of a corporation may occasionally need to take on additional debt to secure a business objective.[65] Thus, the tort of deepening insolvency could effectively render these directors personal guarantors of these business decisions, which runs against the gambit of corporate law that seeks to give directors substantial deference in their business decisions.[66] Other concerns were the redundancy of deepening

theory of damages for malpractice action, but plaintiff alleged damages on other grounds); Liquidating Tr. of the Amcast Unsecured Creditor Liquidating Trust v. Baker (*In re* Amcast Indus. Corp.), 365 B.R. 91, 119 (Bankr. S.D. Ohio 2007) (holding deepening insolvency not recognized in Ohio); Schnelling v. Crawford (*In re* James River Coal Co.), 360 B.R. 139, 180 (Bankr. E.D. Va. 2007) (finding deepening insolvency not recognized in Virginia); Kaye v. Dupree (*In re* Avado Brands, Inc.), 358 B.R. 868, 888 (Bankr. N.D. Tex. 2006) (rejecting deepening insolvency theory); Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, L.L.C. (*In re* Radnor Holdings Corp.), 353 B.R. 820, 848–49 (Bankr. D. Del. 2006) (finding deepening insolvency "to be an impermissible measure of damages"); Christians v. Grant Thornton, L.L.P., 733 N.W.2d 803, 812 (Minn. Ct. App. 2007) (disapproving of deepening insolvency theory); Commercial Fin. Servs., Inc. v. J.P. Morgan Sec., Inc., 2007 OK Civ App 8, ¶ 11, 152 P.3d 897, 900 (holding deepening insolvency "not a recognized measure of damages").

60. Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Trust v. Billett, No. 495, 2006 , 2007 WL 2317768 (Del. Aug. 13, 2007) (recognizing that deepening insolvency began to fall into disfavor).

61. *See id.* at 175–86 (describing facts of case)

62. *See id.* at 204 ("Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate."). The ruling was part of a subsection of the opinion entitled "Delaware Law Does Not Recognize a Cause of Action for So-Called 'Deepening Insolvency.'" *See id.*

63. *See* Trenwick Litig. Trust v. Billet, 931 A.2d 438, at *1 (Del. 2007) ("[T]he final judgment of the Court of Chancery should be affirmed on the basis of and for the reasons assigned by the Court of Chancery in its opinion dated August 10, 2006.").

64. *See Trenwick*, 906 A.2d at 204–08 (explaining holding that Delaware law does not recognize tort of deepening insolvency).

65. *See id.* (hypothesizing consequences of deepening insolvency and how it would affect directors' ability to occasionally take on more debt to save company).

66. *See id.* at 205 ("If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it

insolvency with similar breach of fiduciary duty and fraud claims.[67] Ultimately, when the Delaware Chancery Court struck down deepening insolvency, many assumed the tort would fade into obscurity.[68]

Shortly after the Delaware Chancery Court published its opinion in *Trenwick*, the Third Circuit started to backtrack on its expansive *Lafferty* holding through its decision in *CitX*.[69] There, the Third Circuit dealt with a bankruptcy trustee suing a debtor's accounting firm for professional malpractice and deepening insolvency.[70] The *CitX* holding had three significant effects: (1) it unequivocally rejected deepening insolvency as a theory of damages for claims such as professional malpractice or breach of fiduciary duty, (2) it limited the definition of deepening insolvency to acts of fraud, and (3) it explicitly limited deepening insolvency's applicability to Pennsylvania.[71]

The *CitX* holding appeared to signal the beginning of the end for deepening insolvency in Pennsylvania and the Third Circuit in general, perhaps more so than the *Trenwick* holding from Delaware.[72] After *Laf-*

does not become a guarantor of that strategy's success."). The idea of giving deference to the business decisions of corporate managers—such as directors and officers—comes from the business judgment rule, a common law tenet widely followed by many state jurisdictions. *See* Robert Sprague & Aaron J. Lyttle, *Shareholder Primacy and the Business Judgment Rule: Arguments for Expanded Corporate Democracy*, 16 STAN. J.L. BUS. & FIN. 1, 8 (2010) (reviewing history of business judgment rule). There are a number of reasons why courts employ the business judgment rule, but the overall focus is to maximize wealth. *See id.* ("Scholars argue that '[w]ealth is maximized when corporations are run by directors who know that their decisions will be reviewed by investors, by analysts, by stockholders, and by business partners—but not by the courts.'" (quoting David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, 32 J. CORP. L. 301, 303 (2007))).

67. *See Trenwick*, 906 A.2d at 205 (explaining that deepening insolvency is redundant to other claims that shareholders can bring against directors and officers of corporation). The Delaware Chancery Court then clarified that just because deepening insolvency is not a valid claim, it does not mean it is giving directors more leeway for misconduct. *See id.* ("The rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility. Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud.").

68. *See* Harner & Brighton, *supra* note 27, at 1 (explaining effect of *Trenwick* decision as signaling end for deepening insolvency).

69. *See* Seitz v. Detweiler, Hershey & Assocs. (*In re* CitX Corp.), 448 F.3d 672, 681 (3d Cir. 2006). For a discussion on how the Third Circuit limited its holding in *Lafferty* through its holding in *CitX*, see *supra* note 27 and accompanying text.

70. *See In re CitX* at 674–77 (discussing facts of case). In *CitX*, the Third Circuit dealt with a bankruptcy trustee suing an accounting firm that was alleged to have provided the financial statements used to fraudulently procure investor funds and prolong the life of a corporation that was clearly insolvent. *See id.* (reviewing contextual background facts).

71. *See* Mahoney, *supra* note 27, at 1009 (describing significance of *CitX* decision and how it limited expansive holding of *Lafferty*).

72. *See* Fehribach v. Ernst & Young L.L.P., 493 F.3d 905, 908–09 (7th Cir. 2007) (using *Trenwick* and *CitX* holdings to support conclusion that deepening insolvency is not valid independent claim); Joseph v. Frank (*In re* Troll Commc'ns,

ferty, many viewed the Third Circuit as the harbinger of deepening insolvency, so when the court essentially limited *Lafferty*'s holding only a few years later, it was an unexpected development.[73] In fact, numerous publications were released in response to the *CitX* decision, most of which predicted deepening insolvency's decline.[74] Nevertheless, the Third Circuit did not overtly strike down deepening insolvency in Pennsylvania and the tort survived, albeit in what many assumed to be a deteriorated state.[75]

III. THE THIRD CIRCUIT REVIVES DEEPENING INSOLVENCY IN THE *LEMINGTON* DECISION

In the years after *CitX*, deepening insolvency was greatly marginalized.[76] Directors, officers, accountants, and lawyers breathed a collective sigh of relief as almost everyone predicted that the *CitX* holding would

L.L.C.), 385 B.R. 110, 121–22 (Bankr. D. Del. 2008) (citing *CitX* in context of invalidating deepening insolvency as independent cause of action in Delaware). The *Troll* decision is in stark contrast to the decision by the same court only a few years prior in *In re Exide Techs., Inc.*, which evidences the extremely volatile nature of deepening insolvency in federal courts. *See* Official Comm. of Unsecured Creditors & R2 Invs., LDC v. Credit Suisse First Bos. (*In re* Exide Techs., Inc.), 299 B.R. 732, 752 (Bankr. D. Del. 2003) (holding that Delaware law would support deepening insolvency as independent cause of action).

73. *See* Jo Ann J. Brighton, *Deepening the Blows Against Deepening Insolvency?*, AM. BANKR. INST. J., Sept. 2006, at 24, 24 ("*CitX* has dealt quite a blow to the theory of deepening insolvency."). In fact, a few days after the Third Circuit came out with its holding in *CitX*, the United States Bankruptcy Court for the Southern District of New York, applying Delaware law, dismissed a deepening insolvency claim on the basis that *CitX* explicitly limited the tort to Pennsylvania law. *See* Official Comm. of Unsecured Creditors of Verestar, Inc. v. Am. Tower Corp. (*In re* Verestar, Inc.), 343 B.R. 444, 476 (Bankr. S.D.N.Y. 2006) ("And even more recently the Third Circuit . . . went out of its way to observe, 'nothing we said in *Lafferty* compels any extension of the doctrine beyond Pennsylvania.'" (quoting *In re* CitX Corp., 448 F.3d 672, 680 n.11 (3d Cir. 2006))).

74. *See* Brighton, *supra* note 76, at 24 (describing reaction to *CitX*); Mahoney, *supra* note 27, at 1017 (arguing that *CitX* decision limited *Lafferty* court's expansive holding).

75. *See CitX*, 448 F.3d at 673 (discussing holding of case where *Lafferty* precedent is not overruled but limited).

76. *See* McDonald et al., *supra* note 22, at 61 ("As the development of the deepening insolvency theory indicates and recent decisions make clear, deepening insolvency cannot exist as a theory of liability—either as a freestanding cause of action or theory of damages—without undermining existing legal doctrines."). Only a few years ago and prior to *CitX*, it appeared that deepening insolvency would become the tort of choice for unsecured creditors of bankruptcy corporations. *See* Mahoney, *supra* note 27, at 1018 ("Five years ago, trustees' and creditors' committees seemed poised to plunder the deep pockets of corporations' auditors, directors and lenders under an emerging theory of liability known as deepening insolvency."). However, since the *CitX* decision, the future of deepening insolvency appeared to be in doubt. *See id.* at 1018–19 ("In its recent *CitX* decision, the Third Circuit drastically narrowed the misguided expansion of deepening insolvency by predicating deepening insolvency on fraud, emphatically rejecting deepening insolvency as a measure of damages and limiting the precedential scope of *Lafferty* to Pennsylvania.").

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render deepening insolvency a feeble tag-along tort at best.[77] Nevertheless, such comfort proved to be premature.[78] Through its recent holding in *Lemington*, the Third Circuit explicitly clarified two important points: (1) absent an en banc decision that overrules *CitX* and *Lafferty*, deepening insolvency is still a viable claim in Pennsylvania, and (2) while the tort is still a viable claim, it will be readily enforced.[79]

A. *The Facts Surrounding the Revival*

Lemington Home for the Aged ("Lemington"), a non-profit corporation, operated a nursing home considered to be a historic landmark in Pittsburgh, Pennsylvania.[80] Mary Peck Bond, the daughter of a local abolitionist, founded the home in 1877 to care for the swelling population of destitute and elderly African Americans in the city.[81] From this modest beginning, the home expanded and continued its operations in Pittsburgh for over a century, becoming the oldest elderly care facility in the country by 2005.[82] Nevertheless, starting in the 1980s, the home was beset with financial and managerial problems.[83] By 1999, Lemington operated at a loss and became completely insolvent.[84] To compound the financial

77. *See Third Circuit Limits Scope of Liability for "Deepening Insolvency"*, BANKR. BULL. (Weil, Gotshal & Manges L.L.P., New York, N.Y.), Aug., 2006, *available at* http://www.weil.com/news/pubdetail.aspx?pub=8572 ("Accordingly, it is encouraging that the Third Circuit rejected the opportunity to expand *Lafferty*, and instead chose to limit *Lafferty*'s reach. While the Third Circuit in *CITX* did not elaborate on its rationale for limiting causes of action of deepening insolvency to situations where, as in *Lafferty*, the defendants engaged in intentional fraud, it is likely that the court observed the possible perils that would befall failing companies from the widespread acceptance of a stand–alone cause of action of deepening insolvency arising from mere negligence. Instead, plaintiffs must prove liability under traditional theories, such as negligence and malpractice. It is also significant that the Third Circuit, one of the foremost proponents of recognizing a cause of action of deepening insolvency, decided to limit the types of conduct that could lead to deepening insolvency liability. Other courts may once again follow the Third Circuit's lead and limit the types of conduct that could lead to deepening insolvency liability.").

78. For a discussion on how a few large law firms reacted to the *Lemington* holding, see *supra* note 29 and the accompanying text.

79. *See* Official Comm. of Unsecured Creditors v. Baldwin (*In re* Lemington Home for the Aged), 659 F.3d 282, 292 (3d Cir. 2011) (reversing and remanding lower court's summary judgment dismissal of plaintiff's deepening insolvency claim).

80. *See id.* at 285 (discussing history of Lemington elderly care home).

81. *See id.* (examining factual context of case).

82. Rick Stouffer, *Lemington Home for the Aged Files for Bankruptcy*, PITTSBURGH TRIB. LIVE (Apr. 14, 2005), http://www.pittsburghlive.com/x/pittsburghtrib/s_323974.html ("The Lemington Center is acknowledged as the nation's oldest continuously operating African-American-sponsored long-term care facility for the elderly.").

83. *See Lemington*, 659 F.3d at 285–87 (discussing how financial condition of Lemington deteriorated starting in 1980s).

84. *See id.* (addressing facts of case).

problems, in 2004 two members of the home died in circumstances that suggested neglect.[85]

The committee of unsecured creditors (appellant) alleged that the board of directors for Lemington had contemplated bankruptcy after these deaths, but did not actually file until over a year later.[86] During this time, the directors investigated options such as loans and mergers, but everything fell through and bankruptcy appeared to be a foregone conclusion.[87] Between January and March of 2005, Lemington's board met to discuss future plans for bankruptcy and how to handle the home in the meantime.[88] In these meetings, the board decided to stop admitting new patients to the home and enacted a plan to transfer the home's principal charitable asset to Lemington Elder Care, a sister facility.[89] Lemington's board of directors all simultaneously served on the board for Lemington Elder Care.[90] Eventually, Lemington filed for bankruptcy in April, 2005.[91] For purposes of appellant's deepening insolvency claims, the crucial fact was that Lemington's board definitively decided to file for bankruptcy in January, 2005, but operated the home at a deficit before actually filing in April, 2005—a delay of four months.[92]

After Lemington failed to come up with a buyer during a bankruptcy conference held on June 23, 2005, the bankruptcy court ordered the

85. *See id.* at 286–87 (discussing two negligence related deaths that occurred in Lemington). The court gave the impression that from the year 1999 forward, the Lemington home was in utter disarray, stemming primarily from their chief administrator being completely unqualified for the position. *See id.* ("In 2001, a study funded by the Pittsburgh Foundation recommended that the Board replace Causey with a 'qualified, seasoned nursing home administrator' . . . ."). Furthermore, the Chief Financial Officer for Lemington failed to keep any accurate financial records. *See id.* ("In December of 2002, Defendant James Shealey became the Home's Chief Financial Officer. Shealey failed to maintain a general ledger, and the Home's financial and billing records were in deplorable condition.").

86. *See id.* at 286 (discussing how Lemington's chief administrator suggested bankruptcy in 2004, one year earlier than when board decided to actually file for bankruptcy).

87. *See id.* at 287 ("At its meeting on January 6, 2005, the Board considered options in case a proposed merger with the University of Pittsburgh Medical Center did not occur. The Board considered two options: bankruptcy and restructuring.").

88. *See id.* (discussing background facts of case and specifically when Lemington's Board met to discuss bankruptcy and future plans).

89. *See id.* ("[N]otes from a Board meeting held on March 15, 2005 indicate discussion of plans to transfer the Home's principal charitable asset, the Lemington Home Fund, held by the Pittsburgh Foundation, to Lemington Elder Care, an affiliated entity.").

90. *See id.* at 285 (describing how Lemington's board members were all members of another board for affiliated corporation).

91. *See id.* at 288 ("On April 13, 2005, the Home filed a voluntary Chapter 11 petition in the United States Bankruptcy Court for the Western District of Pennsylvania.").

92. *See id.* at 287 (discussing how Board did not file for bankruptcy until April 2005).

home to be closed and its residents transferred to other facilities.[93] The appellants filed an adversarial proceeding against Lemington's board and officers, alleging breach of fiduciary duties and deepening insolvency.[94] Subsequently, the joint defendants filed for summary judgment and the district court granted the motion, holding that the business judgment rule applied to preclude the plaintiff's breach of fiduciary duty claims.[95] The district court also found that the appellants failed to allege enough facts suggesting fraud to have a viable deepening insolvency claim, and even if they did allege sufficient facts, the *in pari delicto* defense precluded the claim as well.[96]

B. *The Third Circuit Affirms that Deepening Insolvency Exists as an Independent Tort Claim*

The Third Circuit began its discussion of the appellant's deepening insolvency claim by acknowledging that the cause of action had not yet been recognized by the Pennsylvania state courts.[97] However, citing its own precedent in *CitX*, the court set forth the necessary framework for claimants to allege deepening insolvency.[98] More specifically, the *Lemington* court held that deepening insolvency exists as a tort claim in Pennsylvania when it can be proven that an injury to corporate property occurred through the "fraudulent expansion of corporate debt and prolongation of corporate life."[99] Reiterating the holding of *CitX*, the court

93. *See id.* at 289 (examining bankruptcy hearing).

94. *See id.* (describing procedural posture of case and appellant's claims).

95. *See id.* at 291 ("The District Court, however, found that the business judgment rule as well as the doctrine of *in pari delicto* applied to shield the directors and officers from liability."). The business judgment rule has been codified in Pennsylvania. 15 PA. CONS. STAT. ANN. § 5715(d) (West 2011) ("Absent breach of fiduciary duty, lack of good faith or self-dealing, any act as the board of directors, a committee of the board or an individual director shall be presumed to be in the best interests of the corporation."). The purpose of the business judgment rule has been explained by the Pennsylvania Supreme Court as follows:

> The business judgment rule should insulate officers and directors from judicial intervention in the absence of fraud or self-dealing, if challenged decisions were within the scope of the directors' authority, if they exercised reasonable diligence, and if they honestly and rationally believed their decisions were in the best interests of the company. It is obvious that a court must examine the circumstances surrounding the decisions in order to determine if the conditions warrant application of the business judgment rule.

Cuker v. Mikalauskas, 692 A.2d 1042, 1048 (Pa. 1997). For a further discussion of the business judgment rule and its origins, see *supra* note 69.

96. *See Lemington*, 659 F.3d at 289 (describing district court's holding).

97. *See id.* at 293 ("This cause of action has not been formally recognized by Pennsylvania state courts.").

98. *See id.* at 294 (citing *CitX* case to describe requisite elements for deepening insolvency).

99. *See id.* (quoting *In re Citx Corp*, 448 F.3d 672, 677 (3d. Cir. 2006)) (discussing state of deepening insolvency claims in Pennsylvania) (internal quotation marks omitted).

reaffirmed that mere negligence is not enough to support a deepening insolvency claim.[100] Then the court proceeded to clarify the definition of "fraud," for purposes of deepening insolvency.[101]

Despite affirming the *CitX* court's holding that the tort of deepening insolvency continues in Pennsylvania, the Third Circuit's enthusiasm for this decision was noticeably more tempered than when it first recognized deepening insolvency in *Lafferty*.[102] In footnote six of the opinion, the court recognized that "courts and commentators have increasingly called into question the viability of 'deepening insolvency' as an independent cause of action."[103] Still, the court opined that absent an en banc decision, a precedential opinion such as *Lafferty* cannot be overturned.[104] Additionally, the court implied *Lemington* might be distinguishable from *Lafferty* because the insolvent corporation in *Lemington* was a non-profit, but it declined to raise the issue sua sponte.[105] Such a suggestion does, however, leave the door open for future opportunities to further limit deepening insolvency claims from the expansive precedent of *Lafferty*.[106]

C. *The Third Circuit Demonstrates that Deepening Insolvency Will Still Be Enforced*

Notwithstanding the Third Circuit's apparent acknowledgment of deepening insolvency's debatable validity in footnote six, a closer examination of the court's rationale for vacating the district court order strongly

100. *See id.* ("[A]claim of negligence cannot sustain a deepening-insolvency cause of action.").

101. *See id.* (discussing deepening insolvency). For a discussion of the court's definition of "fraud," see *infra* notes 132–34 and accompanying text.

102. *Compare* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349–53 (3d Cir. 2001) (discussing rationale behind deepening insolvency to hold that Pennsylvania law supports deepening insolvency as independent cause of action), *and* Gregg W. Mackuse, *Damages for "Deepening Insolvency": A Defendant's Worst Nightmare?*, 74 PA. B. ASS'N Q. 42, 42 (2003) ("The [*Lafferty*] decision can have serious consequences for corporate officers and directors as well as for third-party professionals who have dealt with a failed company. . . . The doctrine may become one of choice given the number of bankruptcies and other business failures resulting from current economic conditions."), *with Lemington*, 659 F.3d at 294 n.6 ("As Appellees have noted in their brief, courts and commentators have increasingly called into question the viability of 'deepening insolvency' as an independent cause of action. Even if our precedent is erroneous, however, it can only be overturned by this Court en banc.") (citation omitted).

103. *Lemington*, 659 F.3d at 294 n.6.

104. *See id.* (discussing what it would take to overrule *Lafferty* and invalidate deepening insolvency claim in Pennsylvania).

105. *See id.* ("Moreover, because no party argued that the concept of deepening insolvency may not apply to, or may involve a different standard for, a non-profit corporation, we will not address that issue.").

106. *See id.* (suggesting that distinctions can be drawn between regular corporations and non-profit corporations for purposes of determining deepening insolvency).

implies that the tort will be readily enforced.[107] In holding that summary judgment against the appellant's deepening insolvency claims must be vacated, the *Lemington* court cited a number of specific facts.[108] First, the court opined that within the four-month period from when Lemington's board decided to file for bankruptcy and when the corporation actually filed, significant damage was caused "to the detriment of its creditors."[109] Second, the court noted the potential for fraud in the directors' decisions to: delay the bankruptcy filing, cease admitting new patients, not disclose their financial situation to creditors, and omit key information about expenses in the post-petition operating reports required by the bankruptcy court.[110] Next, the court implied that *in pari delicto* did not preclude the appellant's deepening insolvency claims because there was evidence that the board's fraudulent actions—such as transferring Lemington's assets to other entities—were on its own behalf, triggering the adverse interest exception to the equitable defense.[111] Additionally, the court in *Lemington* noted that the appellees continued to conduct business with vendors after deciding to file bankruptcy and failed to collect Medicare receivables.[112]

The culmination of all of these facts led the Third Circuit to hold that—"in the light most favorable to the [appellants]"—a reasonable jury could find that the appellees committed deepening insolvency.[113] But if the court in *Lemington* wanted to marginalize deepening insolvency with-

107. *See id.* at 295 (finding district court's summary judgment dismissal "inappropriate" because there existed "a genuine issue of material fact as to whether the directors and officers fraudulently contributed to deepening the insolvency" of Lemington Home).

108. *See id.* at 293–95 (examining facts of case which led to court's holding on appellant's deepening insolvency claims).

109. *See id.* at 295 (noting appellant's allegations that Lemington board's actions caused harm to corporation).

110. *See id.* at 294 (discussing how appellees omitted expenses in post-petition monthly reports to bankruptcy court).

111. *See id.* at 293–94 (discussing *in pari delicto* defense and adverse interest exception). The *Lemington* court did not explicitly discuss the *in pari delicto* defense in the context of the appellant's deepening insolvency claim, but rather examined the equitable defense in the context of the appellant's breach of fiduciary duty claims. *See id.* However, in the *Lafferty* holding, the court applied *in pari delicto* to affirm the district court's summary judgment dismissal of the deepening insolvency claims as well as the breach of fiduciary duty claims. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 344 (3d Cir. 2001) ("We conclude that 'deepening insolvency' constitutes a valid cause of action under Pennsylvania state law . . . . However, evaluating the Committee's claims . . . we hold that because the Committee, standing in the shoes of the debtors, was *in pari delicto* with the third parties it is suing, its claims were properly dismissed."). Consequently, the Third Circuit implies that *in pari delicto* and the adverse interest exception can run against both fiduciary duty and deepening insolvency claims. *See Lemington* 659 F.3d at 293–94 (discussing adverse interest exception to *in pari delicto*).

112. *See Lemington* 659 F.3d at 294–95 (examining facts pertinent to deepening insolvency claim).

113. *See id.* at 295 (holding that summary judgment dismissal against appellant's deepening insolvency claims should be vacated).

out completely overturning *Lafferty*, this case provided ample leeway to do so. This is because, as the district court held, evidence of fraudulent intent in *Lemington* was tenuous, especially considering that the facts did not indicate a clear motive to defraud.[114] Thus, unlike *CitX* and *Lafferty*, which dealt with ponzi schemes, it would have been plausible to conclude that the board of directors for Lemington was merely grossly negligent.[115] This is corroborated by the fact that in many of the meetings where the allegedly fraudulent decisions took place, attendance by members of the board was less than fifty percent.[116] In the end, however, the *Lemington* court faced a judicial coin-flip, with facts that could have gone equally for or against the deepening insolvency claim.[117] By vacating the summary judgment order and landing on the appellant's side, the Third Circuit strongly implied its willingness to enforce the controversial tort—sending a clear message that deepening insolvency is still alive and well.[118]

IV. THE IMPACT OF *LEMINGTON*'S HOLDING ON THE CURRENT THIRD CIRCUIT JURISPRUDENCE

Following the *Lemington* decision, many law firms with significant practice groups or clients in Pennsylvania noted that deepening insolvency "is back."[119] But as the *Lemington* court mentioned in footnote six, an outright reversal of *Lafferty* and *CitX* was never the expected outcome, bar-

114. *See id.* at 293–95 (discussing facts relevant to determining presence of fraud for purposes of deepening insolvency review); *see also* Official Comm. of Unsecured Creditors v. Baldwin, No. 10-800, 2010 WL 4275252, at *12 (W.D. Pa. Oct. 25, 2010) ("[P]laintiff has failed to create a material issue of fact regarding the claims of fraud. There are simply no facts by which a reasonable trier of fact could find that defendants committed or precipitated any type of fraud. At most, their actions amount to negligence . . . ."), *vacated*, 659 F.3d 282 (3d Cir. 2011).

115. *See Baldwin*, 2010 WL 4275252, at *12 (opining that conduct of Lemington's board, at most, amounts to gross negligence but not fraud).

116. *See Lemington*, 659 F.3d at 287 ("Attendance at Board meetings was often below 50%.").

117. *See id.* at 285–96 (discussing facts of case and considerations for deepening insolvency claim).

118. *See Watch Out Directors and Officers: Third Circuit Keeps "Deepening Insolvency" Action Alive*, NEWS (Pachulski, Stang, Ziehl & Jones L.L.P., Wilmington, Del.), Nov. 30, 2011, *available at* http://www.pszjlaw.com/news-97.html (discussing "return" of deepening insolvency in wake of *Lemington*); ALERT MEMO, *supra* note 29 (warning clients that deepening insolvency is back in Third Circuit); *Court Finds Material Issues of Fact Regarding Breach of Fiduciary Duties and Deepening Insolvency*, CR&B ALERT (Reed Smith L.L.P., Pittsburgh, Pa.) Dec. 2011, at 7, *available at* http://www.reedsmith.com/files/Publication/1c9b37ad-7a77-436f-94fe-42c0858e5ecb/Presentation/PublicationAttachment/be87db9f-54bf-44b8-9de9-60e934cf33eb/crab1211.pdf ("[T]he case expands creditors' abilities to hold directors and officers accountable for the mismanagement of corporations."); INSIGHTS, *supra* note 29 (discussing return of deepening insolvency in wake of *Lemington* holding by Third Circuit).

119. For a discussion of law firms that have taken notice of the *Lemington* decision, see *supra* notes 29 and 115 and accompanying text.

ring an en banc decision.[120] Thus, what is most startling about the *Lemington* holding is not that the Third Circuit reaffirmed the viability of deepening insolvency in Pennsylvania, but that the court actually supported a deepening insolvency claim based on the facts of the case.[121] Consequently, *Lemington* is significant to the Third Circuit jurisprudence on deepening insolvency for three principle reasons.[122] First, the holding applies the framework for a deepening insolvency claim set out by *CitX*.[123] Second, it explicitly defines "fraud" for purposes of determining deepening insolvency.[124] And finally, it gives notice to corporations and bankruptcy practitioners by providing a factual example of what is sufficient for a deepening insolvency claim to survive summary judgment in the post-*CitX* jurisprudence.[125]

A. *Clarifying the Framework Set Forth By* CitX

Following the *Lemington* decision, practitioners should be aware that a successful deepening insolvency claim must prove three elements: (1) "an injury to the debtor's corporate property" (2) caused by (3) "fraudulent expansion of corporate debt and prolongation of corporate life."[126] Again, the Third Circuit has reiterated that for a deepening insolvency claim, negligent actions that inadvertently prolong a corporation's life are not enough, even if such actions cause a detriment to corporate value.[127] Consequently, a successful claim must include factual allegations of fraud.[128]

120. *See Lemington*, 659 F.3d at 295 n.6 (discussing need for en banc review to overturn precedential opinion).

121. *See generally Third Circuit Revives Committee's Deepening Insolvency and Breach of Fiduciary Duty Claims*, THE BANKR. STRATEGIST, (ALM Media Props., L.L.C., New York, N.Y.), Dec. 2011, *available at* http://freebornpeters.com/custom/BankruptcyStrategistArticle_1.3.2012.pdf (discussing how *Lemington* holding puts directors and officers of insolvency corporations on notice that creditors will be scrutinizing their actions prior to filing for bankruptcy).

122. *See generally* Joao F. Magalhaes et al., *The Sword and the Shield: More on the Old Tale of Deepening Insolvency and in Pari Delicto Doctrine*, AM. BANKR. INST. J., Jan. 2012, at 32, 75 (characterizing fraud as "more relevant" determination in the *Lemington* case).

123. *See Lemington*, 659 F.3d at 294 (examining deepening insolvency framework in post-*CitX* jurisprudence)

124. *See id.* (defining fraud for purposes of deepening insolvency).

125. *See id.* at 285–96 (discussing facts relevant to holding that district court's summary judgment order against appellant's deepening insolvency claims be vacated).

126. *See id.* at 294 ("[W]e stated that 'deepening insolvency' in Pennsylvania is defined as 'an injury to [a debtor's] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.'").

127. *See id.* (maintaining that negligent actions are insufficient to prove deepening insolvency).

128. *See id.* (reaffirming *CitX* holding that element of fraud is necessary for a valid deepening insolvency claim).

B. *Defining "Fraud" For Purposes of Deepening Insolvency*

Although the court in *CitX* made it clear that fraud needed to be present in order to have a valid deepening insolvency claim, it never explicitly defined fraud.[129] Thus, in *Lemington*, the court took this extra explanatory step and defined fraud as "anything calculated to deceive, whether by single act or combination, or by suppression of truth, or a suggestion of what is false, whether it be by direct falsehood or by innuendo, by speech or silence, word of mouth, or look or gesture."[130] This definition is taken from common law rather than statutes, and essentially holds that fraud is "any artifice by which a person is deceived to his disadvantage."[131] By clarifying the definition of fraud, the *Lemington* holding gives practitioners a better understanding what type of misconduct is necessary to successfully raise a deepening insolvency claim.

C. *Providing an Example of How a Deepening Insolvency Claim Can Survive Summary Judgment*

Given that summary judgment is a crucial stage in the timeline of litigation, the *Lemington* decision is especially important for practitioners on both sides of the docket.[132] Prior to *Lemington*, the Third Circuit did not have a precedential case in which a deepening insolvency claim survived summary judgment.[133] Even in *Lafferty*, the Third Circuit affirmed the district court's summary judgment ruling against the appellant's deepening insolvency claim for equitable defense reasons.[134] Accordingly, there are a number of lessons to be learned from *Lemington*, where the appellants successively raised a deepening insolvency claim strong enough to survive summary judgment.

First, any delay after a board has officially decided to file for bankruptcy can be significant.[135] In *Lemington*, the court was highly suspicious

129. *See* Seitz v. Detweiler, Hershey & Assocs. (*In re* CitX Corp.), 448 F.3d 672, 680–81 (3d Cir. 2006) (mentioning fraud as requisite for deepening insolvency claim, but not elaborating on definition of fraud for purposes of deepening insolvency).

130. *See Lemington*, 659 F.3d at 294 (quoting *In re* Reichert's Estate, 51 A.2d 615, 617 (Pa. 1947)) (stating definition of fraud under Pennsylvania law).

131. *Id.* (quoting *In re* Reichert's Estate, 51 A.2d 615, 617 (Pa. 1947)).

132. *See id.* at 285 (mentioning procedural posture of case). For a discussion on how the *Lemington* holding was noticed by bankruptcy and corporate law practitioners in large law firms, see *supra* note 121 and accompanying text.

133. *See CitX*, 448 F.3d at 681 (discussing holding and affirming district court's summary judgment dismissal of appellant's deepening insolvency claims); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 344 (3d Cir. 2001) (affirming district court's summary judgment reversal of appellant's deepening insolvency claims).

134. *See Lafferty*, 267 F.3d at 344 (holding that appellant's deepening insolvency claims were properly dismissed). For a further discussion of the Third Circuit's holding in *Lafferty*, see *supra* notes 54–55 and accompanying text.

135. *See Lemington*, 659 F.3d at 293–94 (discussing appellee's delay in filing for bankruptcy and implying this to be significant in determination of fraud).

of the four-month delay between the board's decision to file bankruptcy and the actual filing date, and this became sufficient to create an inference of fraud.[136] Had the corporation's board filed for bankruptcy promptly, their liability would have most likely been limited to breach of fiduciary duty claims.[137]

Next, evidence of self-dealing can be used to trigger the adverse interest exception to the *in pari delicto* defense. In *Lafferty*, the court affirmed summary judgment against the appellant's deepening insolvency claims because it held that the directors' fraudulent acts could be imputed to the corporation, and therefore, *in pari delicto* applied.[138] The board members for Lemington, however, did not engage in any large scale fraud through the corporation, but they did transfer the corporation's assets to other entities under their control.[139] The *Lemington* court ruled that this type of fraudulent self-dealing act could not be imputed to the corporation and *in pari delicto* did not apply.[140]

Finally, proving fraud is the key to having a successful deepening insolvency claim. Realistically, as a non-profit corporation that had been struggling for years, Lemington's overall value most likely did not significantly diminish because its board decided to prolong the corporation's life by four months.[141] However, the Third Circuit appeared to overlook actual damages and focused on evidence of fraud.[142] For future litigation involving deepening insolvency, proving or disproving the fraud element will be crucial.[143]

136. *See id.* (addressing facts suggesting questions of fraud being present).

137. *See id.* (pointing first to delay in bankruptcy filing as evidence of fraud). Although the court discussed other factors that led it to believe fraud could be present, most of these factors arose from the board's failure to file the bankruptcy promptly. *See id.* at 294 ("The Committee alleges that fraud 'is apparent in the Board's failure to disclose to the creditors and the Bankruptcy Court the Board's decision made in January 2005 to close the Home and deplete the patient census, while delaying the bankruptcy filing until April 2005 . . . .'").

138. *See Lafferty*, 267 F.3d at 360 ("[W]e find that the *in pari delicto* doctrine bars the Committee, standing in the shoes of the Debtors, from bringing its claims against Lafferty.").

139. *See Lemington*, 659 F.3d at 288 (noting how Lemington's board transferred corporate assets to other entities in their control).

140. *See id.* at 293 ("Because the Committee has tendered sufficient evidence that the directors' and officers' . . . did not benefit the Home but instead benefited their own self-interest, the applicability of the 'adverse interest' exception presents a genuine issue of material fact. Summary judgment on this basis is therefore inappropriate.").

141. *See id.* at 285–90 (discussing corporation's financial struggles starting in 1980s and continuing until its bankruptcy in 2005).

142. *See id.* at 293–95 (focusing on determining fraud while reviewing appellant's deepening insolvency claims).

143. *See* Magalhaes et al., *supra* note 125, at 75 (characterizing fraud as "more relevant" determination in the *Lemington* case).

V. CONCLUSION

Within a decade, the Third Circuit both catalyzed and corralled the movement towards validating the tort of deepening insolvency with its decisions in *Lafferty* and *CitX*, respectively.[144] The addition of the *Lemington* holding to the overall jurisprudence shows that the Third Circuit has, yet again, surprised practitioners in bankruptcy law. Ultimately, deepening insolvency still appears to be on the decline and only time will tell whether the decision in *Lemington* will have the effect of actually reviving support for the controversial theory.[145] However, in Pennsylvania, as long as deepening insolvency continues to be a valid independent cause of action, the Third Circuit has made at least one thing clear—the much maligned tort will be enforced.[146]

144. *See* Jonathan Friedland, *Fiduciary Duties of Insolvent Corporations—Deepening Insolvency*, STRATEGIC ALTERNATIVES FOR DISTRESSED BUSINESSES § 17:18 (2012) (discussing how *Lafferty* holding expanded deepening insolvency and subsequent *CitX* decision limited it).

145. *See* Fawkes, *supra* note 124 ("While it may be a stretch to read the Third Circuit's decision beyond the particular facts and circumstances of the *Lemington Home* case—particularly with respect to its holding regarding deepening insolvency . . . .").

146. *See* Magalhaes et al., *supra* note 125, at 32 ("Contrary to many other parts of the country, the tort of 'deepening insolvency' appears to be alive and well in Pennsylvania.").